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Crisis in Canadian Banking

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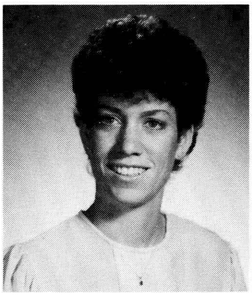

Introduction

Until the autumn of 1985, Canada's highly concentrated and loosely regulated banking industry had gone for 62 years without a bank failure. But in early September 1985, two Alberta institutions, Canadian Commercial Bank (CCB) and Northland Bank, collapsed. These were Canada's tenth and eleventh largest banks respectively. Mismanagement and poor conditions in energy lending and real estate in Canada's western region were the main causes of ruin for the two wholesale banks.

CCB and Northland were relatively young banks, created in the mid-1970s in response to the Western prairie capitalist's call for a regional banking system. Many small businessmen in Western Canada felt alienated from the six large banks that dominate Canadian banking. These businessmen hoped that the creation of regional banks would provide the desired expansion of credit in Western Canada which was at that time a region booming from the thriving oil industry. Their wish came true. Eight regional banks were created in the mid-1970s. However, by 1985 two of the eight young banks had failed. Additionally, Mercantile Bank of Canada was damaged by bank runs caused by the panic following the failure of CCB and Northland, and was subsequently taken over by National Bank of Canada. Later a fourth bank—Continental Bank of Canada—was liquidated.

The creation of regional banks has greatly altered Canada's banking system. However, the change in the banking system was not accompanied by a change in the banking regulatory system, especially in the area of examination. In this paper, I argue that if Canada wishes to retain regional banking to answer the needs of small businesses, the regulatory system will have to undergo significant changes, especially in its examination capacity. Furthermore, I show that regardless of whether Canada chooses to retain the regional banking system, current bank regulation is inadequate.

I proceed by first giving a detailed account of the factors leading to the collapse of Canadian Commercial Bank (CCB) and Northland.

Next, I examine the consequences of these bank failures upon Canada's banking system, taxpayers, shareholders and bank regulation; and I conclude by discussing the future of Canadian bank regulation.

Overview Of The Canadian Banking System

Canada's banking system has two tiers: 1) Schedule A banks, which are owned by Canadians, and 2) Schedule B banks, which are under foreign control. Schedule A banks control 94% of Canada's domestic assets while Schedule B banks control the remaining 6% (Hanley, 1985, p.5). Before the collapse of CCB and Northland, the Canadian banking industry consisted of 14 domestic banks (see Table 1). Control of 95% of the country's bank assets is concentrated in Canada's Big Six: Royal Bank of Canada, Bank of Montreal, Canadian Imperial Bank of Commerce, Bank of Nova Scotia, Toronto Dominion Bank and National Bank of Canada. At the time of their collapse, CCB and Northland Bank together accounted for less than 1% of Canadian bank assets.

Regulation of Canadian Banks began in 1923, after the failure of the Home Bank of Canada. At this time, the Office of the Inspector General of Banks was instituted. The Inspector General is responsible to the Minister of Finance and conducts an annual examination of each bank to ensure compliance with the Bank Act. The Bank Act is Canada's law governing its banking activities. The Act is revised every ten years.

Salomon Brothers conducted a study of Canadian banks in November 1985. In its opinion, the role of the Inspector General of Banks tends to be reactive rather than proactive in regards to bank problems (Hanley, 1985, p.4). The Office of the Inspector General reacts to the demonstrated performance of banks by means of oral or written guidelines (Hanley, 1985, p.4). For example, rather than issuing specific regulations to tighten control over the banks, the Inspector General of Banks typically

TABLE 1
CANADIAN BANKS

Ranked by assets as of July 31, 1985 and their provisions for loan losses for the period October 31, 1985 to July 31, 1985.

BANK	HEADQUARTERS	1985 ASSETS, IN BILLIONS ($C)	LOAN LOSS RESERVES, IN MILLIONS ($C)
Royal Bank of Canada	Montreal	$91.7	$463.0
Bank of Montreal	Montreal	80.0	311.7
Canadian Imperial Bank of Commerce	Toronto	73.8	360.0
Bank of Nova Scotia	Toronto	58.1	224.2
Toronto Dominion Bank	Toronto	50.3	191.9
National Bank of Canada	Montreal	21.5	97.1
Continental Bank of Canada	Toronto	6.2	22.9
Mercantile Bank of Canada	Montreal	4.4	20.9
Bank of British Columbia	Vancouver	3.2	10.3
Canadian Commercial Bank*+	Edmonton	2.7	7.2
Northland Bank*	Calgary	1.4	4.8
The Morguard Bank of Canada	Vancouver	0.3	0.8
The Western & Pacific Bank of Canada	Vancouver	0.1	0.2
Bank of Alberta	Edmonton	0.1	n.a.

* Banks that failed.

+ Bank closed Sept. 1, 1985. Data for period Oct. 31, 1984 to June 30, 1985.

Source: The Canadian Bankers Association data as presented in the *New York Times* October 4, 1985, p. D1.

discusses new rules with bank representatives before their introduction. Additionally, although the Inspector General's Office conducts a limited review, it is the bank's internal and shareholder auditors who actually conduct the annual examination of each bank (Hanley, 1985, p.4).

The Rise And Fall Of The Western Canadian Banks

Creation of the Western Banks

Unlike American banks, Canada's Big Six are national in scope, offering complete branch banking services through nearly 7,000 branches across the country. However, in the opinion of many Western Canadians, the Big Six could not or would not address the needs of the Western prairie capitalists (*Maclean's,* November 4, 1985, p. 52). Many Canadians felt that as the Big Six became larger, they lost the incentive to compete, which often resulted in higher interest rates for consumers and small businessmen. The high interest rates especially hurt the small businessmen in need of credit who are located in Western Canada. According to Alan Wade (November 1985, p. 31), some Western Canadians have the same dislike for Toronto's big banks that some Americans have for New York's. Such feelings of alienation fueled the dream of creating regional banks which would not ignore the needs of a particular region.

The economic booms of the 1960s and 1970s which centered upon the thriving Canadian oil industry led to an increased demand for the expansion of credit. Many Western Canadians dicovered they could not secure loans from the national banks and trust companies based in Central Canada (*Maclean's,* November 4, 1985, p. 52). Even those who did secure loans from the Big Six reportedly complained of "high-handed treatment." Economist Warren Blackman presented one example of this "high-handed treatment" in *Maclean's,* when he noted that the Big Six "would unilaterally shift money from a business's deposit account to put against a loan without consultation" (*Maclean's,* November 4, 1985, p. 52).

In an effort to escape the feelings of bank alienation, the provinces began to apply political pressure to the Prime Minister for the creation of regional banks. In 1973, four western provinces argued in a brief to Prime Minister Trudeau that western banks would "infuse effective competition into the banking industry in the securing of deposits and the making of loans, (thereby) extending considerably greater assistance to the small-scale and risky ventures" (*The Banker,* February 1986, p. 40).

The call for regional banks became successful with the creation of eight such banks during the mid-1970s. The advent of regional banking represented a significant change in Canada's banking system. However, the regulatory system was not altered to parallel the change in the banking system, especially in the area of examination. For example, the regional banks tended to concentrate in energy loans — especially in oil, a notorious "boom to bust" industry. This alone prompted the regulators to examine the regional banks more closely.

Two Alberta banks, Canadian Commercial Bank (CCB) and Northland, were created in 1976. CCB of Edmonton was formed as a commercial bank, whose primary purpose was to make loans to small businesses. Calgary-based Northland Bank was formed to meet the increasing demands for sizeable loans from Western businessmen in the energy and real estate sectors. Both new banks expanded rapidly, concentrating on the then-booming energy and real estate sectors in Alberta and British Columbia. At the time, Alberta produced over 85% of Canada's petroleum and gas, with the majority of petroleum and gas firms headquartered in Calgary (*Business America,* p. 15).

Alberta's economy was hit hard in 1982 with a combination of falling energy demand, record high interest rates and a Canadian (and worldwide) recession (*Business America,* p. 15). The deep recession hit the young banks especially hard. Oil and commodity prices declined in the early 1980s, as the demand for oil fell (*The Banker,* February 1986, p. 40). Usage of drilling rigs decreased to 30% in 1982, down from a 43% utilization rate in 1981. Real estate prices also declined. According to William Hancock, Vice-President of Royal LePage Commercial Real Estate Services in Calgary, the upward trend of Alberta real estate prices reversed sharply in early 1982; and by 1983 real estate prices had fallen on average by a disastrous 50%, back to their 1978 levels (*Maclean's,* April 8, 1985, p. 31). Additionally, Alberta's unemployment rate rose from 3.8% in 1981 to 11.2% in 1984. This sudden increase in unemployment caused many homeowners to default on their mortgage payments. In 1984, for example, Alberta experienced 8,023 foreclosures, compared to only 626 in 1981 (*Maclean's,* April 8, 1985, p. 31). As a result, financial institutions were left with mortgage loans whose collateral had plummeted 50% in value.

The Fall of Canadian Commercial Bank

Mismanagement plays a part in all bank failures. In 1981, CCB president G. Howard Eaton recommended expanding CCB through Westlands Bank of Santa Anna, California, a company that was carrying a large percentage of risky loans to U.S. energy companies. CCB acquired 39% of Westlands in 1981. During the recession, CCB's president skipped town and country to move to California. A *Maclean's* article (December 23, 1985, p. 26) reports that "instead of condemning the move, the bank's board approved an interest-reduced loan of $1 million to help him (Eaton) settle snugly in Santa Barbara" where he supposedly ran CCB by long-distance telephone conversations. Meanwhile, a 1982 Inspector General inspection of CCB revealed its lack of diversification. Two-thirds of CCB's uncollected interest was on energy property loans and another 16% was on energy-related assets (*The Banker,* February 1986, p. 40).

More scandalous than Eaton's move to California was his association with Leonard Rosenburg, "the controversial Ontario-based financier whose trust company empire crumbled in notoriety and was taken over by the Ontario government" (*Maclean's,* September 23, 1985, p. 31). With Eaton's help, Rosenburg became CCB's largest shareholder, purchasing 27% of the bank's shares without the knowledge of the board's directors. According to the Bank Act, a single shareholder is not allowed to own more than 10% of a domestic bank. Peter C. Newman of *Maclean's* (December 23, 1985, p. 26) questioned the wisdom of allowing Rosenburg to control a Schedule A bank when he could not operate a small trust company. Eaton was forced to resign on January 23, 1983, after his relationship with Rosenburg was made public. Gerald McLaughlan succeeded Eaton as CCB's president.

After Eaton's resignation, the Bank of Canada Governor, Gerald Bouey, telephoned *The Globe and Mail* to tell reporters that, despite the Rosenburg connection, the CCB was still at that point in time "a solvent and profitable bank" (*Maclean's,* December 23, 1985, p. 26). Also Eaton's successor, Gerald McLaughlan, did not attempt to reverse the issuance of risky loans. Despite this, both Bouey and the Minister of State for Finance (Barbara McDougall) continuously issued assurances about CCB's financial health.

In 1984, the U. S. Federal Deposit Insurance Corporation (FDIC) examined Westlands and found serious problems, including hazardous lending, lax collection processes, inadequate loan provisions and poor management. The FDIC subsequently notified the Inspector General of Banks (*Canadian Business,* December 1985, p. 149). The fact that a U. S. regulator tolled the first warning bell to a Canadian regulatory agency depicts the severe weakness of Canadian bank regulation, especially in the area of examination.

CCB suffered a loss of C$6.9 million for the fiscal year ending October 31, 1984 (*Maclean's,* April 8, 1985, p. 31). As reported in *Maclean's* (April 8, 1985, p. 1) the loss was mainly the result of $194 million in nonperforming loans (loans on which interest has not been paid for more than 90 days) and interest revenue falling. Although still suffering from the financial strains in Alberta and apparently unaffected by the FDIC findings, CCB acquired the remaining 61% of Westland's assets in June, 1984.

Endangering CCB's financial position further was the reduction in oil prices. On January 30, 1985, the official price of oil was lowered by $1.40 to $39.20 per barrel by OPEC (*Canadian Business,* December 1985, p. 34). As a result, exploration for oil was cut back drastically. For

CCB, this meant that U. S.-based oil and gas drilling companies ceased interest payments to Westlands on $100 million in loans (*Maclean's,* April 8, 1985, p. 31). After selling the collateral backing of the loans and still facing bad Canadian real estate loans, CCB faced a loss of about $89 million in 1985 (*Maclean's,* September 23, 1985, p. 31). Consequently in March 1985 CCB sought help from the Canadian government. At that time Gerald McLaughlan, CCB's second president, asked William Kennett, the Inspector General of Banks, for a bailout.

The Fall of Northland Bank

Like CCB, Northland bank suffered from the recession in Western Canada. Northland Bank's asset base was also heavily concentrated in the energy and real estate sectors of Alberta and British Columbia. Basically, however, it was Northland Bank's rapid growth and risky lending practices which eventually led to its demise. The bank had grown from $388 million in assets in 1981 to $1.3 billion by mid-1985 (*Maclean's,* October 7, 1985, p. 40). This stunning growth, fed by the oil boom of pre vious years, was not uncommon in Alberta during this period.

One example of Northland's aggressive and risky banking procedures was its decision to refinance Calaway Park (an amusement park) after several previous lenders (Bank of Canada and Bank of America Canada) decided that the project was too risky. Northland took over the two banks' loans at 55 cents on the dollar, leaving itself with a total loan of $13 million (*Maclean's,* October 7, 1985, p. 40). This was quite risky considering the state of the economy and the projections that the amusement park would be in the red for several years to come.

The federal government's announcement of a rescue package for CCB in March, 1985, in turn provoked nervous depositors to withdraw huge amounts of funds from Northland; for the announcement seemed to illuminate the risky lending practices of regional banks in general. Thus it was that financial problems—largely the result of the aggressive and risky loan-making procedures, coupled with the deep recession—led the government to close Northland's doors six months later on September 1, 1985.

The Attempted Rescue Of CCB And Northland

On March 24, 1985, Canada's federal government announced a C$255 million rescue package for CCB. The bailout was financed by the federal and provincial governments along with the Big Six. Canada's Big Six contributed a total of C$60 million to the bailout.

The rationale behind the bank rescue appeared valid at the time. Bank regulators were concerned over the financial panic that might ensue since Canada had not witnessed the demise of one of its own banks for 62 years. The rescue package was intended, therefore, to restore investor confidence and to halt any runs on all regional banks. The federal government was also responding to political pressure to save a regional bank.

The Inspector General of Banks, William Kennett, proposed that CCB could be restored as a viable bank with the aid of the rescue package and through the sale of the bank's real estate assets. Instead of being able to sell the real estate assets at 55% of their value, as estimated by the bank's auditors, however, the bank subsequently found it could only unload the assets at 30–35% of their value (*Maclean's,* September 23, 1985, p. 30). This mistake only served to intensify the controversy and thus created additional problems for CCB's attempted rescue.

Rather than simply restoring investor confidence, the announcement of the bailout had an unintended side effect: it illuminated the financial problems of CCB and other small institutions. As a result, depositors began withdrawing funds from CCB and from other small banks. After the initial rescue attempt, CCB depositors withdrew C$1.6 billion of approximately C$2.8 billion of deposits (*Maclean's,* September 23, 1985, p. 30). Some claim that even the Big Six banks, which had contributed C$60 million to the C$255 million rescue package, removed large amounts of deposits (*United States Banker,* p. 29). Meanwhile, depositors also began to pull funds out of Northland Bank as the banking crisis spread.

Thus, the federal government's intention of restoring confidence in the regional banks had failed.

In response to the rapid withdrawal of funds by depositors, the Canadian government continued to pour in loans to CCB and Northland to maintain liquidity. By July 1985, the Bank of Canada had injected a total of C$1.6 billion into CCB, compared to the C$17 million which it had provided before the bailout in March (*Canadian Business,* December 1985, p. 149). Canadian law only allows this sort of aid to floundering banks for six months. Thus, in September 1985, the loans ceased.

Concurrently, George Hitchman, former deputy chairman of the Bank of Nova Scotia, was appointed to investigate CCB's books. In August 1985, Hitchman completed his report. Hitchman found that of CCB's C$2.4 billion in loans, C$1 billion were worthless (*Canadian Business,* December 1985, p. 150). His report also cited unacceptable banking practices and mismanagement. Additionally, Hitchman discovered that internal documents identified C$471 million in bad loans. However, only C$83 million of that total had become part of the C$255 million rescue package (*Canadian Business,* December 1985, p. 150). How such a substantial amount of bad loans could escape the eyes of the bank's board, auditors and the Inspector General remains unclear.

In summary, the bailout of the banks was flawed in two ways. First, the initial C$255 million was based on an inaccurate appraisal of the CCB's condition. Second, instead of restoring investor confidence as intended, news of the bailout provoked a crisis in depositors' confidence in the regional banking system as a whole. Thus, faced with a banking crisis that appeared to be getting progressively worse, the federal government closed the doors of both CCB and Northland on September 1, 1985. The Bank of Canada had provided more than C$1.6 billion in short-term loans to CCB and $699 million to Northland (*The Banker,* October 1985, p. 9).

These two bank failures were to have far-reaching effects, many of which will be discussed in the following section. In October 1985, Prime Minister Brian Mulroney appointed Supreme Court Justice William Zebedee Estey to investigate the bank failures. In addition to investigating further the reason why the banks failed, the Estey Commission is expected to make recommendations on how to improve Canada's banking system. (The Estey Commission Report was not completed at the time of this writing.)

Ramifications Of The Alberta Bank Failures

Effects on the Other Regional Banks

The Canadian government's attempted bailout of CCB represented a change from the traditional method of dealing with banks in difficulty, which was to merge ailing banks with larger ones. As already noted, the government's unprecedented rescue plan of C$255 million to CCB, intended to calm panic, backfired by alerting investors to the unsound lending practices of regional banks. The government's miscalculation of investor reaction created a wave of unrest in Canada's banking industry as investor speculation resulted in an outflow of funds from the banking institutions and a decrease in investor purchases of smaller banks' commercial paper. Mercantile Bank of Canada, the nation's eighth largest bank, and Continental Bank of Canada, the nation's seventh largest bank, fell victims to the unrest.

Mercantile was the harder hit of the two banks, experiencing withdrawals of $300 million by panicky depositors (*American Banker,* October 16, 1985, p. 1). National Bank of Canada, Canada's sixth largest bank, eventually took over the troubled bank. National benefited from the deal by expanding its assets approximately 20% and enlarging its base outside of Quebec (*The Banker,* February 1986, p. 41).

Continental Bank of Canada (not related to Continental Illinois) also suffered from heavy depositor withdrawals. In an effort to boost the bank's image and investor confidence, 25 officials from the Big Six audited the bank's loan portfolio and concluded that the bank had sufficient reserves for its doubtful loans (*Wall Street Journal).* In September 1985, however, Continental suffered a loss of C$300 million of its total $5.6 billion in deposits (*Canadian Business*, April 1986, p. 80). The favorable audit was not enough to restore public confidence, and so Continental Bank began seeking a buyer. In October 1986, Central Capital, a financial services firm based in Nova Scotia, agreed to purchase the leasing unit of Continental, while Lloyds Bank PLC of Britain agreed to buy most of the remaining assets. Under the agreement with Lloyds Bank, Continental consented to liquidate itself, with the proceeds to be distributed to its holders (*Wall Street Journal).*

Thus the dream of regional banking turned into a nightmare for small banks during what the Canadian press refers to as "Black September." Although the dream of regional banking has been deeply damaged, many still yearn for a less concentrated banking system. As University of Calgary economist Warren Blackman states, "The test of a banking system is not if it fails, but whether or not it meets the needs of the business community" (*Maclean's*, November 4, 1985, p. 52). In reality, however, the failures and mergers have further reduced competition in an already heavily concentrated banking industry.

Effects on Taxpayers, Shareholders and General Public

Although CCB and Northland together accounted for less than 1% of Canadian banking assets, their fall and bailout brought with them considerable expense to taxpayers and shareholders. Taxpayers ultimately footed the bill for the flawed bailouts at an estimated cost of C$875 million (*Maclean's*, November 4, 1985, p. 43). In effect, the taxpayers paid the price to cover losses "incurred by incompetent bankers and imprudent investors" (*Maclean's*, November 4, 1985, p. 44).

CCB shareholders also paid a heavy price. The price of CCB shares plummeted from C$19.62 to $5.25 per share during the two-day halt of trading in March when the bailout was announced (*Maclean's*, April 8, 1985, p. 31). Two of the shareholders of CCB stock lost a combined total of C$355,500. The two shareholders have threatened to file lawsuits if they can prove that CCB issued shares in January, 1984 without revealing its state of affairs. Pension fund losses may amount to an additional $96 million.

Peter C. Newman, analyst for *Maclean's* magazine, wrote in December 1985 about the effect of Canada's banking crisis on the general public. As Newman stated:

> Canadian life has been based, forever it seems, on the sanctity of the three pillars that sustained our individual and collective sense of well-being: the family, God and our chartered banks. One of the pillars in this confidence-sustaining tripod collapsed during 1985, and from now on Canadian bankers will be regarded as nothing more than just another bunch of professionals — like chicken pluckers who didn't quite meet their quotas (*Maclean's*, December 23, 1985).

Obviously, the strong belief in the stability of the Canadian banking industry was severely jolted by the events of 1985.

Effects on Regulation

Inspector General of Banks

The Canadian press repeatedly blamed the Office of the Inspector General of Banks for its failure to detect the poor quality of loans issued by the two Alberta banks, despite regular examinations. In May 1985, the House of Commons Committee on Finance, Trade and Economic Affairs launched its own investigation of the bailouts. The Commons Committee findings included an internal log from 1981 to 1985 that listed sixteen occasions on which the Inspector General of Banks had had contact with CCB (*Canadian Business*, December 1985, p. 151). Additionally, officials of the U. S. Federal Reserve Bank of San Francisco on February 20, 1985 had telephoned Inspector General Kennett's office, alerting him of the problems with CCB's U. S. Subsidiary, the Westlands Bank (*Canadian Business*, December 1985, p. 34). Yet, it was not until March 1985, when CCB asked for a bailout, that the Inspector General of Banks had reacted. As *Maclean's* reported, "(It must be determined) whether Kennett was misled by the banks, whether he lacked the tools to determine a bank's solvency or whether he was not vigilant enough" (*Maclean's,* February 3, 1986, p. 42).

It should be noted that the Inspector General of Banks had a staff of only forty members during the banking crisis, only eight of them field officers, whose tasks were to cover several institutions spread over half a continent (*Euromoney,* July 1985, p. 69). Subsequent to the failure of CCB, Kennett did, in fact, ask for a larger staff, formal contacts with bank boards and auditors, and an increase in power. But Canada's Bank Act does not give Kennett the power to force a bank to act, although he has access to any and all information about banks under his jurisdiction (*The Gazette).* Barbara McDougall, Minister of State for Finance, is expected to push for legislation to fulfill Kennett's requests.

Canada Deposit Insurance Corporation (CDIC)

The CDIC was created in 1967 after the failure of the Atlantic Acceptance Corporation and the losses suffered by depositors. The purpose of initiating deposit insurance was to restore investor confidence, and deposits were insured to a limit of C$20,000 per deposit in 1967 (*Issues in Bank Regulation,* p. 56). In 1983, the deposit insurance was increased to C$60,000 per deposit.

With the failure of CCB and Northland, the C$60,000 limit on deposit insurance was altered retroactively. Barbara McDougall, Minister of State for Finance, said that special legislation would be passed to pay back *all* uninsured depositors, at an estimated cost of C$420 million to taxpayers (*Maclean's,* September 16, 1985, p. 42). The final cost to taxpayers was, in fact, C$875 million. Not surprisingly, this action provoked severe criticism; for many saw the government's action as one designed to protect large investors who were well aware of the risks associated with placing such funds in risky, regional banks. As Robert Korthals, president of the Toronto Dominion Bank, stated, "It (the action) says that people who have taken imprudent risks are smart and those who have taken lower rates are fools" (*Maclean's,* September 16, 1985, p. 42).

Deposit insurance in Canada has recently become an important regulatory issue because new regulations were not introduced to compensate for the advent of regional banking. The purpose of the CDIC is to restore investor confidence in Canada's banking industry. However, when the CDIC was created twenty years ago, Canada's banking institutions were large, diversified and professionally managed. Today, with Canada's experiment in regional banking and the increasing number of foreign-owned banks, the stability of the banking industry is not so certain. The failures of CCB and Northland typify the changing times, and as is evident from their failures, not all banks are managed professionally with diversified portfolios. According to John McCallum:

> The CDIC was never designed to back wholesale banks with limited geographical and loan diversification in an environment characterized by extreme interest rates exchange rates and business cycle volatility (*Issues in Bank Regulation,* p. 56).

Thus it appears that the changes in Canada's banking industry must be accompanied by parallel changes in the policies of the CDIC.

Effect on the Green Paper

On April 15, 1985, prior to the bank failures, Minister of State for Finance McDougall issued a discussion paper, *The Regulation of Canadian Financial Institutions,* popularly referred to as the "Green Paper." The paper's proposals were designed to bring existing federal legislation up to date with the rapidly changing banking industry in Canada. The Green Paper focused on two major issues: regulation and the need for greater variety of financial services. The major innovation suggested in the paper was to allow greater integration of Canada's "four pillars" (a Canadian phrase referring to commercial banking, insurance, trust and investment dealing) through financial holding company vehicles. More specifically the Green Paper proposed that:

> Through a financial holding company arrangement, nonbank financial institutions could enter the banking industry by establishing a "C" bank subsidiary with full com-

> mercial lending powers; enter the trust industry through a fiduciary subsidiary; enter the insurance industry through an insurance company subsidiary; and enter the securities industry through ownership in an investment dealer firm, to the extent that provincial law allows (Hanley, 1985, p. 6).

Additionally, the changes proposed in the Green Paper would exclude large "A" banks and all "B" banks from forming financial holding companies.

According to Allan Taylor, former chairman of The Canadian Bankers' Association, the failure of the two regional banks succeeded in "putting the expansion of powers of financial institutions in the background and elevated the need in the minds of some for greater regulation and supervision" (*Canadian Banker,* June 1986, p. 22). It is however expected that the issue of schedule "C" banks will surface again in 1990 when Canada's Bank Act is scheduled for revision (Hanley, 1985, p. 7).

The Future Of Canadian Bank Regulation

According to economist Arthur Donner, a consultant to Research Securities of Canada Ltd., "The banking system has changed dramatically in the past ten years but the regulatory system has stayed the same. It must be overhauled" (*Maclean's,* November 4, 1985, p. 46). As we have seen, the advent of regional banking in Canada has not been accompanied by stricter regulation and a closer inspection and supervisory system of the banking industry. All this has led Liberal Leader John Turner to exclaim recently, "This (the government's role in bank closings) is a monumental, billion-dollar goof on the part of the government" (*Maclean's,* September 23, 1985, p. 30). This being the case, what changes in regulation can we expect to see after the dust has finally cleared?

As previously discussed, the failures of CCB and Northland and the paying back of uninsured depositors at taxpayers' expense have hurled the CDIC into the spotlight of the Canadian controversy over the banking crisis. It is expected that future regulation will strengthen the role of the CDIC by providing the regulatory agency with new powers of examination and the ability to seize assets and change management. Additionally, a premium hike proposal (one which calls for premiums of one-tenth of one percent on insured deposits) is expected to raise $172 million a year to slowly cut the CDIC's deficit. Previously, premiums had only brought the CDIC $51 million annually (*United States Banker,* p. 34).

Regulatory changes which will affect the Inspector General of Banks are also expected. According to the Bank of Canada Governor, Gerald Bouey, "There is no mystery about why the bank (CCB) failed. The only mystery is why we did not know more about the condition of the Bank last March" (*Maclean's,* February 3, 1986, p. 2). Bouey's comment clearly questions the adequacy and effectiveness of the Inspector General's role in bank inspection. Why, for example, did it take so long for the Inspector General to react? Why was it that the regional banks, a new venture in Canadian banking, were not examined more closely? Finally, how could the examination procedures have led to such severe miscalculations on the value of the bank's assets?

It is expected that in the near future the office and powers of the Inspector General of Banks will be strengthened. Current recommendations from the Minister of State for Finance include the addition of fourteen more staffers to the agency, an increase in the amount of training received by the staffers and an improvement of relations with the bank's appointed auditors (*Canadian Business,* December 1985, p. 150). More important, the Inspector General of Banks is currently requesting "cease and desist" powers, which would be far more effective than simply moral suasion. Cease and desist powers (which U. S. regulators possess) would enable the Inspector General of Banks to block objectional acquisitions or deals.

A technological overhaul of the country's inspection system is also desperately needed. As columnist George Hitchman writes, "The (bank) inspection system in this country is a sick joke. Our banks have up-to-date computers but our examination system is based on green eyeshades" (*United States Banker,* p. 29). McDougall is also pushing to update the regulatory offices to include more state-of-the-art data systems.

Conclusion

Although CCB and Northland together accounted for less than 1% of Canadian bank assets, their demise created a major controversy for Canada. Since 1923, when the Home Bank of Canada collapsed because of fraudulent lending practices, the Canadian government had not presided over a single bank failure. Perhaps out of practice, the government's attempt to financially "prop" the banks failed. The regional banking crisis succeeded in illuminating the weaknesses in Canadian bank regulation, while increasing the power of the already giant Big Six. If Canada desires regional banking to survive, bank regulation must undergo change. However, even if the dream of regional banking is abandoned, Canadian bank regulation is in need of reform, especially in the area of bank examination.

Although the concept of regional banking was severely damaged in 1985, many still support the idea. The Big Six's image was once again enhanced with the failure of the two regional banks and subsequent runs on other banks. Many fear that the concentrated power the Big Six already possess (they currently control 95% of Canadian banking assets) will be increased still further in years to come, due to the current lack of confidence in the regional banking system and the shelving of the Green Paper's idea of schedule "C" banks. It is also feared that such further concentration could increase the alienation of prairie capitalists. According to Allan Taylor, former chairman of the Canadian Bankers Association, "We're a young country. We need young businesses and financing for them" (*Canadian Banker,* p. 23). Further regulation is not only necessary to strengthen the regional banking system but ultimately to spur on the growth of small business in Canada.

Bank regulation in Canada is expected to undergo changes which may make Canadian bank regulation more similar to that in the United States. For example, the cease and desist powers desired by the Inspector General of Banks are similar to those in the U.S. regulatory system. But although a change in Canadian bank regulation is needed, many question the sense of merely copying the U. S. model — a nation which had 79 bank failures in 1984 and 120 in 1985 (out of approximately 14,500 total banks in the U. S.). However, the failures are not the issue. The issue is the weakness of the bank regulatory system in Canada, a system which failed to recognize and react to the blatant problems at CCB until it was too late. Canadian bank regulation can be expected to incorporate changes that increase the power of the regulatory system by enabling the regulators to diagnose bank problems and to react to them more quickly. Changes in regulation are necessary for the entire banking system, especially if Canada desires to support the concept of regional banking which will ultimately enhance growth in the small business sector.

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